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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-1588

RALPH NASH, *et al.*,

Petitioners,

vs.

FARMERS NEW WORLD LIFE INSURANCE COMPANY, *et al.*,

Respondents.

Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

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Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States of America:

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above case on February 8, 1978.

I.
OPINIONS BELOW.

A copy of the Opinion and Order of the United States District Court for the Southern District of Ohio, Eastern Division (not reported) is attached to this petition as Appendix A. A copy of the Opinion of the United States Court of Appeals for the Sixth Circuit is attached to this petition as Appendix B and is officially reported in 570 F.2d 558 (1978).

II.

JURISDICTION.

The opinion of the United States Court of Appeals for the Sixth Circuit was decided and filed on February 8, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

III.

QUESTIONS PRESENTED.

(1) Under appropriate analysis of state law governing the pendent claim of plaintiff class, did the corporate fiduciary defendants fail to meet their burden of proving the fairness of forcing plaintiff class to exchange 2.5 shares of OSLICO (after adjustment for splits) for a share of Farmers when defendants had been in complete control of both companies since they obtained control through a similar exchange at a ratio of 1:1?

(2) Did the trial court err by innovating a justification of the forced exchange ratio in terms of the arithmetical relationship between the adjusted book value of a share of OSLICO and the market price of a share of the combined companies (Farmers)?

IV.

STATUTES AND REGULATIONS INVOLVED.

Section 10 of the Securities Exchange Act of 1934 [15 U.S.C. §78j] and Rule 10b-5 [17 C.F.R. §240b-5 (1977)] are set out in Appendix C.

V.

STATEMENT.

Defendant FARMERS GROUP, INC. (FGI) has long managed a group of California insurance "exchanges," groupings of reciprocal-type pools of property and casualty insurance policies. FGI derived earnings from operation of a large "captive" sales force of insurance salesmen required to sell exclusively for the "Farmers group of related companies," and derived earnings also from administering the exchanges as attorney-in-fact.

In 1957 FGI management decided to add life insurance as a "piggy-back" product for the Farmers captive sales force of property and casualty insurance agents. To that end, FGI acquired as a subsidiary New World Life Insurance Company, a moribund Washington company, in an exchange of newly issued FGI stock, changing the name to Farmers New World Life Insurance Company ("Farmers").

Over the years 1957 to 1965, sales of Farmers life insurance policies steadily advanced as increasing numbers of the several thousand members of the existing captive Farmers sales force became licensed and learned to sell life insurance policies along with automobile and fire policies.

A phenomenon of finance of life insurance companies is that large amounts of capital are required to back up high numbers of new sales of policies, because of reserves necessary from the policies' inception, and from high sales commissions in the first years of such sales. In an old company in which older policies predominate, free of sales commissions and earning profit beyond amounts of premium committed to neces-

sary reserves, the additional surplus created from profit from old policies may exceed additional capital requirements stemming from new writings. In 1965 the pattern for Farmers New World Life was the predominance of an increasing growth of new sales and the concomitant need for additional capital or for ceding or reinsuring policies into other companies rather than reserving for them.

In 1965 management of FGI was approached with the opportunity to acquire Ohio State Life Insurance Company ("OSLICO"), which they did through a combination of paying insiders cash at a premium above market and holding a public tender offer exchanging shares of the FGI subsidiary, Farmers New World Life, for shares of OSLICO. OSLICO was a company at the time with several times the capital and surplus of Farmers New World Life, and a sales force of only a few hundred. Its mix of business was predominantly old policies on the books for many years; its new sales were therefore not draining capital.

The exchange ratio was one share of Farmers New World Life exchanged for one share of OSLICO. Both companies had had active public markets for their stocks at the time, and the recent ranges of market prices had been similar to the 1:1 ratio negotiated in the exchange.

The result of the tender offer was that Farmers New World Life acquired 95% of the stock of OSLICO, which it held and kept off the market through 1972.

From 1965 until 1972, FGI controlled operations of both Farmers and OSLICO from the FGI headquarters in Los Angeles, with local management also, respectively, in Washington, and Columbus, Ohio. The

larger "Farmers Group" sales force continued to sell only policies issued by the Farmers New World corporation and the smaller sales force of OSLICO continued to sell only policies issued by the OSLICO corporation.

From the 1965 acquisition until 1972 the market pricing for stock of the combined companies (Farmers) remained relatively strong. The market for the remaining 5% of OSLICO shares in public hands was weak, with little volume and quotations sometimes unavailable.

In the fall of 1972, FGI management decided to effect a forced merger by which the 5% of OSLICO stock in public hands would be eliminated so that Farmers would own 100% of the OSLICO stock. They wanted to complete the forced merger before the year's end when SEC Rule 145 would go into effect, subjecting such a transaction to the requirement of registration with the SEC.

Under the merger formula devised by FGI management and adopted by the boards of its life insurance subsidiaries, the remaining 5% public shareholders of OSLICO would receive one share of Farmers stock for each two shares of OSLICO stock they exchanged. Compared to the exchange in the 1965 tender offer, and adjusted for intermediate splits, the public OSLICO shareholders would be giving up 2.5 shares of OSLICO for each share of Farmers received, compared to the 1:1 exchange in 1965.

Before the end of 1972 the merger was effectuated and the minority holding in OSLICO extinguished. Members of the plaintiff class of minority stockholders of OSLICO eliminated by the merger independently brought class actions claiming abuse of fiduciary duties by the controlling shareholders and securities fraud

in the federal courts for the Southern District of Ohio and for the Central District of California. Upon a motion by defendants, the action in the Central District of California was transferred to the Southern District of Ohio, where the two cases were subsequently consolidated and tried. The basis for the trial court's jurisdiction was Sections 12 and 17 of the Securities Act of 1933, 15 U.S.C. §77a-77z, as amended; Sections 10(b), 14, and 27 of the Securities and Exchange Act of 1934, 15 U.S.C. §78a-78hh, as amended; and Rules 10b-5 and 14a-9 thereunder.

The trial court granted judgment for the defendants on all counts. The Court of Appeals for the Sixth Circuit affirmed.

VI.

REASONS FOR GRANTING THE WRIT.

A. By Avoiding Any Legal Analysis of the State Claims for Abuse of Control Pendent to a Conventional 10b-5 Federal Question Claim, Both Lower Courts Produced a Result Inconsistent With What This Court Had to Have Intended in Santa Fe Industries, Inc. v. Green.

The Court of Appeals confronted an important issue of federal law concerning the administration of claims under Section 10b of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, in tandem with claims under state law regulating abuse of fiduciary duty toward minority shareholders by unjustifiably expanding this Court's holding in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 51 L.Ed.2d 480, 95 S.Ct. 1292 (1977). In that case, this Court held that minority shareholders who challenge the fairness of a short-form merger by means of a Rule 10b-5 claim

must allege manipulation or deception, not just unfairness of the terms; otherwise the federal courts have no jurisdiction to hear the federal claim and consequently any state claims brought in conjunction with the Rule 10b-5 claim must also fail. In contrast to *Santa Fe Industries, Inc.*, the case at bar involves pleadings and evidence of serious misrepresentations and omissions in the majority shareholder's proxy statement, clearly falling within this Court's view of the proper scope of a Rule 10b-5 claim, as well as pleadings and evidence of a claim for abuse of control under state law. Unlike *Santa Fe Industries, Inc.*, which merely concerned sufficiency of pleading a Rule 10b-5 claim, the case at bar comes up on a full record after trial of a class action on the merits. Yet the Court of Appeals concluded that because plaintiffs were unsuccessful in the lower court on their claim of deception under Rule 10b-5, an analysis of the law governing plaintiffs' claim under state law at either the district or appellate level was unnecessary. In so doing, the Court of Appeals has sanctioned an unacceptable departure by a lower court from the usual course of judicial proceedings through an incorrect use of the holding in *Santa Fe Industries, Inc.*, thus calling for an exercise of this Court's power of supervision. SUP. CT. R. 19.

The minority stockholder plaintiffs in *Santa Fe Industries, Inc.* challenged in federal court a short-form merger of their company with its corporate parent which was conducted fully in compliance with Delaware law. The basis for federal jurisdiction was a Rule 10b-5 claim which alleged only that plaintiffs had been treated unfairly by a fiduciary: Plaintiffs alleged that they received an unconscionably low price from management for their stock, the merger took place

without prior notice to them, and that it had no justifiable business purpose. In addition, the complaint alleged a breach of fiduciary duty under state law. This Court held that mere unfairness was an insufficient basis for a Rule 10b-5 claim in the context of "going-private" transactions; the conduct alleged had to be fairly viewed as manipulative or deceptive within the meaning of the statute. Since defendants had not engaged in manipulation or deception, this Court held that plaintiffs' claim failed to state a cause of action under federal securities law and thus sanctioned the lower court's dismissal of plaintiffs' state claim for lack of pendent jurisdiction.

In direct contrast to the manner in which the plaintiffs in *Santa Fe Industries, Inc.* pleaded their Rule 10b-5 claim, plaintiff class in the instant case has alleged from the outset that defendants engaged in deceptive conduct with respect to the proxy statements issued the minority shareholders. The evidence before the trial court was mainly documentary and undisputed, with testimonial evidence only on certain limited points as allowed by the trial judge through pretrial procedure. Accordingly, although the Court of Appeals in this case made repeated reference to its need to defer to the factual determinations of the trial judge as the trier of fact, in this instance the appellate courts are as well positioned to evaluate evidence of the key facts as the trial judge.

While the district court and Court of Appeals found against plaintiff class on the issue of defendants' misrepresentation, both courts below provided no discussion whatsoever of the law bearing on the pendent claim for abuse of control. Although this Court in *Santa Fe Industries, Inc.* clearly refrained from construing

Section 10b and Rule 10b-5 from regulating all sorts of abuses of control by corporate fiduciaries, that opinion is no support whatsoever for refraining from adequate analysis of an abuse of control claim properly pendent to a conventional Rule 10b-5 claim for misrepresentations and omissions in proxy materials concomitant to the merger. Yet the Sixth Circuit, after expounding curiously on the absence in this case of pleading or proof of conventional market rigging or manipulation, and then holding that misrepresentations were pleaded and sought at length to be proved, disposed of the entire legal analysis of the pendent claim in one sentence in a footnote, as had the trial court.

Petitioner class submits that even after *Santa Fe Industries, Inc.*, minority shareholders with abuse of control claims along with proper claims of misrepresentations under Rule 10b-5 have an absolute right to prosecute their case in federal courts having exclusive jurisdiction over the latter sort of claims. Moreover, petitioner class submits further that in such situations the plaintiffs can and should expect from the federal judiciary the same hawkeyed and determined insistence that corporate fiduciaries' power be "at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis" as this Court mandated in 1939. *Pepper v. Litton,* 308 U.S. 295, 311, 84 L.Ed. 281, 292 (1939).

The practical impact of the Sixth Circuit's opinion, however, is to force counsel for a class of minority shareholders of a public company, forced by management to sell out at an unfair price and subjected to misrepresentative proxy materials, to choose between having a legitimate claim under state law being veritably

ignored in federal court should its Rule 10b-5 claim prove unsuccessful, or abandoning its 10b-5 claim altogether (over which the federal courts have exclusive jurisdiction) in order to obtain adequate application of state law standards by a state court. Such a result prevents effective administration of the securities laws in a manner wholly unintended by this Court when it pronounced its opinion in *Santa Fe Industries, Inc.* Favorable consideration of this petition for writ of certiorari will therefore permit this Court to exercise its supervisory function over the lower federal courts to insure adequate attention to pendent state securities claims joined with legitimate Rule 10b-5 claims.

The apparent deficiencies of both of the courts below in failing to provide a detailed analysis of the pendent claim for breach of fiduciary duty in terms of authorities and standards are worse yet since they occurred in conjunction with egregious errors in factual determinations, as will be explained below, that had a determinative effect on that pendent claim.

B. The Courts Below Were Clearly in Error in Finding and Affirming the Finding That Defendant Fiduciaries Proved They Had Acted Fairly in Forcing the Merger by Giving Plaintiffs One-Third of What Was Negotiated on the Previous Exchange When Defendants Had Been in Absolute Control of Both Companies in the Interim.

A pronounced vice of the opinions of both of the courts below is that if they had followed the actual steps necessary to analyze the pendent claim in terms of the unquestionably established state law on corporate fiduciaries they inevitably would have found for the plaintiff class. The burden of proof was on FGI and

the other defendants to establish a fair justification for setting the ratio at only about one-third as much as the 1:1 ratio in 1965 when they had assumed absolute control of the destiny of both companies.

Theirs was the burden to prove that any changes to their advantage in the financial relationships of the two companies up until they decided to force the exchange were fortuitous rather than just the results of their own operation for their own benefit. *Ohio Drill & Tool Co. v. Johnson,* 498 F.2d 186, 195 (6th Cir. 1974).

There is no possible way they met that burden.

The standard with which the courts below were obliged to measure defendants' conduct against, remains the one described by Mr. Justice Cardozo in *Meinhard v. Salmon,* 249 N.Y. 458, 164 N.E. 545, 62 A.L.R. 1 (1928):

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Wendt v. Fischer, 243 N.Y. 439, 444, 154 N.E. 303. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

62 A.L.R. 1, 5. As Mr. Justice Cardozo further pointed out, the fiduciary must disgorge advantage he has obtained even though the cestuis has been but a passive investor and has already obtained what the fiduciary thinks he deserved:

> A constructive trust is, then, the remedial device through which preference of self is made subordinate to loyalty to others. Ibid. Many and varied are its phases and occasions. Selwyn & Co. v. Waller, 212 N.Y. 507, 512, L.R.A.1915B, 160, 106 N. E. 321; Robinson v. Jewett, 116 N.Y. 40, 22 N. E. 224; cf. Tournier v. National Provincial & Union Bank [1924] 1 K. B. 461, 12 B. R. C. 1021—C.A.
>
> We have no thought to hold that Salmon was guilty of a conscious purpose to defraud. Very likely he assumed in all good faith that with the approaching end of the venture he might ignore his coadventurer and take the extension for himself. He had given to the enterprise time and labor as well as money. He had made it a success. Meinhard, who had given money, but neither time nor labor, had already been richly paid. There might seem to be something grasping in his insistence upon more. Such recriminations are not unusual when coadventurers fall out. They are not without their force if conduct is to be judged by the common standards of competitors. That is not to say that they have pertinency here. Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer. Clegg v. Edmondson, supra. For him and for

> those like him the rule of undivided loyalty is relentless and supreme. Wendt v. Fischer, 243 N.Y. 439, 154 N. E. 303; Munson v. Syracuse, G. & C.R. Co. 103 N.Y. 58, 74, 8 N. E. 355.

62 A.L.R. 1, 7.

From 1965 to 1972, FGI was in control of the affairs of both subsidiary life insurance companies, running them from its headquarters in Los Angeles. At any time after FGI obtained that control, FGI could have forced the merger it forced in 1972. FGI picked the time to force the merger. FGI set the terms of the merger, which the boards of its two subsidiaries approved without inquiry. As 53% owner of Farmers New World Life, FGI itself stood to gain the bulk of any advantage in the exchange ratio, set by FGI without outside advice, correlative to any disadvantage, or dilution, to plaintiffs.

FGI top management used no outside consultant to determine a ratio. Robert Early, president of FGI, and Rocco DiFonso, his acquisition specialist, did it themselves. DiFonso admitted in his deposition that the ratio was premised upon the relationship of the market prices of the two stocks (with a "premium" for the OSLICO block to be acquired), when they obviously knew at the time and conceded at trial and on appeal that there was no legitimate market at the time for the OSLICO stock. Frequently they could not obtain quotes on the OSLICO stock themselves.

The market was then evaluating the Farmers stock, representing the combination of two fairly equally sized companies, at around $360,000,000 ($60 a share × approximately 6,000,000 shares) on around 2,000,000 shares marketable (FGI was holding its 53% off the

market). At the same time the $14 price of the OSLICO stock indicates that OSLICO was being evaluated by the market in that context at about $28,000,000 ($14 a share × 2,000,000 shares) with defendants holding 95% off the market. Accustomed to directing investment of many millions of insurance companies' assets in the markets, and constantly attentive to the finances of their own companies, DiFonso and Early were fully cognizant that the market quotations for the few shares of OSLICO outstanding were so far out of line as to be invalid as a comparison. Yet, DiFonso admitted that is precisely how they developed the formula they caused to be forced on the minority shareholders. How could that conduct of those fiduciaries in adopting an invalid formula possibly satisfy their burden of proving fair dealing toward the cestuis?

In the proxy materials drafted later, factors were specified as having been considered by the boards of directors of the two subsidiaries in determining the exchange ratio. In specifying those considerations the defendant fiduciaries also failed by far to meet their burden of proof. The reasons given boiled down essentially to the fact that sales had been larger over the 1965-1972 period out of the Farmers corporate entity than out of the corporate entity of its 95%-owned subsidiary OSLICO. But nothing was established that those sales results were anything other than a by-product of the way FGI exercised its control over the subsidiary entities—they deployed the larger original sales force of several thousand agents selling policies issued only out of the Farmers corporate entity and deployed the smaller acquired sales force of several hundred selling policies issued only by the OSLICO corporate entity. FGI also did not direct insurance

to be ceded or reinsured between the two corporate entities. The petitioning class submits that the reasons given in the proxy statement were so obviously not fortuitous but results of the defendants' own doings that defendants should have been held to have shown no justification for departing from the 1:1 ratio negotiated for the 1965 exchange before they assumed complete control.

The deposition testimony was undisputed, however, that the boards of the two subsidiaries did not in fact consider the factors the proxy statement said they considered—in fact they did not even know how DiFonso and Early had come up with the formula. Again, under a proper analysis, the fiduciaries' proof failed markedly.

This case is one of self-dealing by a fiduciary, not an appraisement proceeding. No kind of transaction is more suspect. Over centuries the courts have developed workable ways of holding fiduciaries to appropriate standards, despite the universal difficulties of determinatively ascertaining values. The guardian who buys property from his ward's estate and resells at a profit must simply disgorge the profit. The corporate officer who buys property from the company at a bargain price must simply pay up the differential. *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App.2d 405, 241 P.2d 66 (1952).

The plaintiff class submits that if the courts below had not neglected to apply the evidence step-by-step against the pendent claim for abuse of control, this case would have been decided in a manner favorable to the plaintiff class. FGI and the other defendants forced a transaction between themselves and the plaintiff

class affording the latter only a third of what had previously been set at arms length for similar transactions, and failed to justify the differential they had created in their own favor.

C. The Courts Below Clearly Erred in Justifying the Exchange Ratio by Relating the Book Value of the OSLICO Stock to the Market Price of the Stock of the Combined Companies (Farmers).

The trial court justified the exchange ratio, and the Court of Appeals upheld that justification, on an approach that neither side had used, and for good reason. The trial court concluded that the ratio was justified by the fact that the adjusted book value per share of OSLICO stock as calculated by an expert for the plaintiffs' class was about half of the actual market value of a share of the combined companies (Farmers), which established the fairness of the exchange ratio of two shares of OSLICO for one share of Farmers.

The manner by which the ratio was actually calculated by FGI management, as admitted by its financial officer DiFonso, was premised upon the relationship of the market price per share of the combined companies (Farmers) of about $60 per share, to the market price per share of OSLICO of about $14, with a premium on the market price of the OSLICO stock since a block was being acquired. By the time of trial, however, the defense had sided with the plaintiff class in conceding that the market price at that time of the OSLICO stock was fallacious, as defendants held 95% of the stock off the market, making quotes often unobtainable.

Another test of fallaciousness of the OSLICO market price is the fact that the aggregate market price of the combined companies, of which the OSLICO assets made up about half the value was about $360,000,000 ($60 per share × 6,000,000 shares) while the OSLICO half of that combination as measured by the aggregate price of the OSLICO stock, was about $28,000,000 ($14 per share × 2,000,000 shares).

Still more compelling evidence of the fallaciousness of the market price comparison (ignored by both courts below) is that market price was wholly out of line with other critical factors. In terms of these other factors, this is what the minority received for what it was forced to give up:

	One share OSLICO	for	½ share Farmers
Adjusted stockholder's equity (Book value)	$15.76		$4.69
Earnings	2.01		.76
Dividends	.25		.06

The expert for the plaintiff class had premised his analysis on the belief that comparing market prices of two freely traded stocks was the best way to set an exchange ratio, but this could not be done in this case because there was no valid market for the OSLICO stock. Accordingly, he testified that if such an exchange ratio must be determined at all—and such a determination was necessitated in this instance by defendants' own decisions to force a merger at terms set by them—the next preferred conventional approach was to set the ratio on the relationship of book values of the shares of the two companies, with adjustment for values that do not show up on the

books. His conclusion was that an exchange ratio premised on adjusted book-to-adjusted book would exchange one and one-half shares of Farmers' stock for one share of OSLICO stock. Using this analysis, OSLICO shareholders should have received three times what they received under the exchange ratio set by FGI management.

The defense had two experts. One testified that the plaintiffs' expert had to be off in his calculations of adjusted book value, but never quantified how far off. The other defense expert sought to justify the ratio set by FGI by comparing the actual market price of the combined companies (Farmers) with a market price he invented or reconstructed of what he thought OSLICO stock should in fact be selling for if there were a valid market for it.

Obviously, however, the market at the time was reacting favorably to the stock of the combined companies (Farmers). While its book value per share was around $9, the market price was $60 a share. There is no possible way of differentiating how the investors in the stock market were pricing the stock of the combined companies (Farmers) proportionately as among the two corporations constituting the combination, as the financial reports of the combined companies (Farmers) were consolidated.

Nevertheless, the trial court, volunteering its own lay analysis of the comparative finances of the companies, seized upon the arithmetical relationship between the adjusted book value plaintiff class' expert calculated for a share of OSLICO stock and the actual market price at the time per share of the combined companies (Farmers) stock. Since such an approach was contended by neither side, there was obviously

no discussion of such an approach nor argument about it in the record at the trial level.

The petitioner class submits that the trial court's innovation of that approach, and the Court of Appeals' affirmation of it, was a reversible departure from appropriate standards of judicial craftsmanship.

More importantly, petitioner class contends that the approach volunteered by the trial court was unreasonable and prejudicial. It produced the worst possible results for the minority shareholders, since it deprived them totally of the benefit of the marketability and high market reception of the combined companies in which they owned proportionately larger portions (with only 2,000,000 shares of OSLICO extant) than the holders of a share of Farmers (with about 6,000,000 shares extant).

The destruction of marketability of plaintiffs' stock was clearly foreseeable to defendants from 1965, when they first took 95% of OSLICO stock off the public market while simultaneously increasing marketability of the Farmers stock by the additional shares issued in exchange. The willingness of the courts below to volunteer a rationalization for an exchange ratio so drastically diluting plaintiffs' interest and depriving plaintiffs of the additional value possible from increased marketability contrasts drastically with the redress given similarly oppressed minority shareholders in *Jones v. H.F. Ahmanson & Company*, 1 Cal.3d 93, 460 P.2d 464, 81 Cal.Rptr. 592 (1969), in which Chief Justice Traynor states why the plaintiff class should be afforded the additional value from marketability:

> Appraisal rights protect the dissenting minority shareholder against being forced to either remain

an investor in an enterprise fundamentally different than that in which he invested or sacrifice his investment by sale of his shares at less than a fair value. (O'Neal and Derwin, Expulsion or Oppression of Business Associates (1961), *supra*, 62.) Plaintiff here was entitled to no less. But she was entitled to more. In the circumstances of this case she should have been accorded the same opportunity to exchange her Association stock for that of United Financial accorded the majority.

Although a controlling shareholder who sells or exchanges his shares is not under an obligation to obtain for the minority the consideration that he receives in all cases, when he does sell or exchange his shares the transaction is subject to close scrutiny. When the majority receives a premium over market value for its shares, the consideration for which that premium is paid will be examined. If it reflects payment for that which is properly a corporate asset all shareholders may demand to share proportionately. (Perlman v. Feldmann, *supra*, 219 F.2d 173.) Here the exchange was an integral part of a scheme that the defendants could reasonably foresee would have as an incidental effect the destruction of the potential public market for Association stock. The remaining stockholders would thus be deprived of the opportunity to realize a profit from those intangible characteristics that attach to publicly marketed stock and enhance its value above book value. Receipt of an appraised value reflecting book value and earnings alone could not compensate the minority shareholders for the loss of this potential. Since

> the damage is real, although the amount is speculative, equity demands that the minority stockholders be placed in a position at least as favorable as that the majority created for themselves.

1 Cal.3d 93, 117-118, 81 Cal.Rptr. 592, 606.

Still another patent example of the trial court's error is its further volunteering that the "simple answer" to why the market prices of the two stocks had grown apart so far, and why the exchange ratio was so fair, was in the differences over the years in the growth of the *aggregate* surpluses of the OSLICO and Farmers corporate entities. Reduced to per share figures, those numbers illustrate the unfairness of the forced exchange ratio. The trial court appears to have been misled by the same blandishments in the proxy statement it found not to have been misleading.

VII.
Conclusion.

Petitioners urge the Court to grant a writ of certiorari in this proceeding.

Respectfully submitted,

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Attorneys for Petitioners.

APPENDIX.

Appeal from the United States District Court for the Southern District of Ohio.

United States Court of Appeals for the Sixth Circuit.

Ralph Nash, et al., *Plaintiffs-Appellants,* v. Farmers New World Life Insurance Company, et al., *Defendants-Appellees.* No. 76-1819.

Decided and Filed February 8, 1978.

Before: Phillips, Chief Circuit Judge, Celebrezze, Circuit Judge, and Markey, Chief Judge of the Court of Customs and Patent Appeals.*

Celebrezze, Circuit Judge. This class action was brought by minority shareholders of the Ohio State Life Insurance Company (OSLICO) seeking damages for alleged violations of the securities laws. The District Court entered a judgment on the merits against Appellants after a bench trial.

Appellees Farmers New World Life Insurance Company (Farmers) is incorporated under the laws of the State of Washington. OSLICO is incorporated in Ohio. In 1965, Farmers purchased ninety-five percent of outstanding OSLICO shares via a tender offer. Seven years later, in 1972, Farmers decided to acquire the remaining shares of OSLICO by effecting a merger,[1] in which OSLICO shareholders would be offered one share of Farmers stock for every two shares of OSLICO stock. At this time, Farmers stock was trading at

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*Honorable Howard T. Markey sitting by designation.

[1]The merger was actually effected between OSLICO and FNW, Inc., a wholly owned subsidiary of Farmers incorporated in Ohio. Farmers created FNW expressly for the purpose of this merger, in order to qualify for certain tax preferences. The capital of FNW consisted of 53,398 shares of Farmers stock.

about $60 per share, while OSLICO stock was trading at about $14 per share.[2]

The Boards of Directors and Shareholders of both corporations[3] approved the proposed merger—OSLICO minority shareholders were thus left with the option of either accepting the merger terms or exercising their rights as dissenters under Ohio Corporation Law. Under the latter procedure, shareholders are entitled to recover the "fair cash value" of their stock as determined by court-appointed appraisers. Ohio Rev. Code Ann. § 1701.85. Several OSLICO minority shareholders did dissent from the merger, and their stock was appraised at a value of $28 per share in the court proceedings.

Appellants subsequently brought this suit, alleging, *inter alia*, that the exchange terms of the 1972 merger were grossly unfair, and that a proxy statement issued in connection with the merger was materially misleading. They sought damages under Rule 10b-5 of the Securities and Exchange Commission, which prohibits the use of "any device, scheme, or artifice to defraud" or the making of any materially misleading statement in connection with the purchase or sale of any security.[4]

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[2]At the time of the merger there was no active market for OSLICO stock, since only 5% of its shares were outstanding. Some trading did take place, however, and the stock generally brought between $10 and $14 per share in those transactions. Both Farmers and OSLICO shares were traded on the over-the-counter market at the time of the merger.

[3]The two companies involved were actually OSLICO and FNW, Inc. *See* note 1, *supra*.

[4]Rule 10b-5 was promulgated under § 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78, which provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[4]Rule 10b-5, 17 CFR § 240b-5 (1976), provides:

> Employment of manipulative and deceptive devices.
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> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The trial court rejected Appellants' claims, finding that the exchange terms were fair and that the proxy statement was not materially misleading. Appellants challenge both of those findings in this appeal.[5]

As to the fairness of the exchange, the issue is essentially one of fact, and the finding of the District Court should not be disturbed unless clearly erroneous. *See Nanfito v. Tekseed Hybrid Co.*, 473 F.2d 537, 541 (8th Cir. 1973). We have reviewed the record and find substantial evidence that the exchange terms were equitable. In receiving one Farmers share (market value, $60) for every two OSLICO shares (market value $14), OSLICO shareholders obtained approximately $30 in cash equivalent for each OSLICO share. Although the market value of OSLICO stock was low at the time of the merger due to an inactive market

[5]The District Court also rejected on the merits a pendent claim of breach of fiduciary duty under state law. We find no error in that holding.

for the stock, none of the experts who testified at trial valued the shares at over $30. As already noted, court appointed appraisers valued the shares at $28 in state proceedings. Based on this evidence, the District Court could reasonably conclude that OSLICO shareholders were adequately compensated in the exchange.[6]

As to the District Court findings that there were no material misrepresentations in the proxy statement, we likewise affirm under the clearly erroneous standard.[7] The Court properly rejected claims by Appellants

[6]The Appellants produced an expert witness who testified that the "intrinsic"—as opposed to market—value of Farmers stock was only $20 per share at the time of the merger, thus suggesting an exchange ratio of one and one-half Farmers shares for each OSLICO share. The District Court was not obligated to follow this valuation in view of other expert testimony indicating a much higher value for Farmers' stock at the time of the merger.

[7]In *Chelsea Assoc. v. Rapanos,* 527 F.2d 1266, 1270 (6th Cir. 1975), we held that a district court's finding of non-materiality of misstatements in a 10b-5 action was reviewable under the clearly erroneous standard. The Supreme Court has since characterized the materiality issue as "a mixed question of law and fact." *TSC Ind. Inc. v. Northway, Inc.,* 426 U.S. 438, 450 (1976). In general, this court does not apply the clearly erroneous rule in reviewing mixed law-fact determinations by a District Court Judge. *See, e.g., United States v. Weingarden,* 473 F.2d 454, 460 (6th Cir. 1973); *Old Dutch Foods, Inc. v. Dan Dee Pretzel & Potato Chip Co.,* 477 F.2d 150, 154 (6th Cir. 1973). In *Northway,* however, the Supreme Court also pointed out that the determination of materiality "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, *and these assessments are peculiarly ones for the trier of fact."* 426 U.S. at 450 (emphasis supplied). In light of this language, we adhere to our decision in *Chelsea Assoc. v. Rapanos, supra,* to review determinations of non-materiality under the clearly erroneous standard. *Cf. Aquionics Acceptance Corp. v. Kollar,* 536 F.2d 712, 714-15 (6th 1976). Of course, the clearly erroneous standard would not apply if we were reviewing a claim that the District Court relied on an improper legal definition of materiality in reaching its findings. *See generally United States*

that failure to state certain items on a per share bias, or to present certain figures on a consolidated basis, was materially misleading. The evidence established that per share and consolidated data could be calculated from other figures presented in the statement. The proxy statement was approximately thirty pages and contained detailed financial statements for both Farmers and OSLICO.

Having found no evidence of unfairness or misrepresentation, the District Court correctly ruled that no violation of Rule 10b-5 had occurred. A claim of fraud or breach of fiduciary duty in a merger states a claim for relief under Rule 10b-5 "only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' " within the meaning of § 10b of the Securities Exchange Act. *Santa Fe Ind., Inc. v. Green,* 430 U.S. 462, 473-74 (1977). "Manipulation" under the Act "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Id.* at 476. Such activities were never alleged in this case. The gravamen of Appellants' claim is that the merger terms were unfair,[8] not that Defend-

v. Parke Davis & Co., 362 U.S. 29, 43-45 (1960); *United States v. United States Gypsum,* 333 U.S. 364, 394 (1948). Plaintiffs make no such claim in this case; they merely challenge factual determinations by the trial court and do not question the legal standard under which those determinations were made.

[8]It should be noted that an allegation of unfairness in merger terms, standing alone, does not state a claim for relief under Rule 10b-5. The fundamental purpose of the Securities Exchange Act was to implement a philosophy of full disclosure; "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." *Santa Fe Ind., Inc. v. Green,* 430 U.S. 462, 477-78 (1977). *See Marsh v. Armanda Corp.,* 533 F.2d 978, 984-86 (6th Cir. 1976), *cert. den.,* 430 U.S. 954 (1977).

ants manipulated prices.[9] Plaintiffs did allege deception, but the District Court disposed of this claim in holding that there were no material omissions or misrepresentations in the proxy statement. *See id.* at 474.

We have considered all of the other claims raised by Appellants and find them to be without merit.

The judgment of the District Court is affirmed.

[9]Plaintiffs maintain that Farmer's 1965 acquisition of 95% of OSLICO shares "destroyed the market" for OSLICO shares. Although this may be true, it hardly amounts to "manipulation" of prices. Plaintiffs concede that the 1965 exchange was fair to all parties.

Opinion and Order.

In the United States District Court for the Southern District of Ohio, Eastern Division.

Ralph Nash, et al, Plaintiffs vs. Farmers New World Life, et al, Defendants. Civil Action 72-475.

Otto G. Green, et al, Plaintiffs vs. Farmers Group, Inc., et al, Defendants. Civil Action 73-398.

Filed: March 30, 1976.

This matter is before the Court for a decision on the merits. These actions originated as separate class actions independently brought in Ohio and California by minority stockholders of Ohio State Life Insurance Company. Plaintiffs complain of the unfairness of a statutory merger which took place in 1972 and allege violations of securities laws in connection with that transaction. The California action was transferred to this court and the cases were consolidated for trial. The parties have submitted extensive documentary evidence and have assisted the Court by preparing summaries of much of the deposition testimony. In addition, the Court held an evidentiary hearing which was devoted principally to the reception of expert testimony. Based upon all the evidence, and pursuant to Rule 52, Federal Rules of Civil Procedure, the Court makes the following findings of fact and conclusions of law.

Findings of Fact

1. The individual plaintiffs in this action are Ralph Nash, Eric and Elizabeth J. Streiff, and Otto G. Green. Plaintiff Ralph Nash is a resident of the State of California. On November 24, 1972, the record date for the solicitation of proxies for the 1972 merger, he owned 20 shares of Ohio State Life Insurance

Company [OSLICO] stock. Plaintiffs Eric Streiff and Elizabeth J. Streiff are residents of the State of Massachusetts and on November 24, 1972 were the joint owners of 1,000 shares of OSLICO stock. Plaintiff Otto G. Green is a resident of the State of California and was the owner of 5,100 shares of OSLICO stock.

2. This action is brought on behalf of the minority shareholders of the Ohio State Life Insurance Company of record on November 24, 1972. The Court has previously found that this action meets the requirements of Rule 23, Federal Rules of Civil Procedure, and has ordered that it proceed as a class action. Following notice to the prospective members of the class, certain persons elected to be excluded from this action.

3. Defendant Farmers New World Life Insurance Company [Farmers] is incorporated under the laws of the State of Washington. Defendant Farmers Group, Inc. [Group] is incorporated under the laws of the State of California. Defendants FNW, Inc. [FNW] and OSLICO are incorporated under the laws of the State of Ohio. FNW was merged into OSLICO on December 31, 1972. Group owns a majority interest in and controls Farmers, and through stock ownership or contractual arrangements owns and/or controls a number of entities engaged in insurance and related businesses.

4. In 1965 OSLICO was a publicly held company with 1,000,000 share outstanding in which there was an active trading market. In that year Farmers offered to exchange one share of its own $1.00 par value stock for each outstanding share of OSLICO stock with par value of $2.00. The offer was conditioned upon receipt of at least 80 percent of OSLICO stock

so that the transaction would qualify as a tax free exchange. At the time of the exchange offer, Farmers did not own any OSLICO stock. However, 210,940 shares of OSLICO stock were owned by Farmers Underwriters Association (which owned 70 percent of the stock of Farmers New World) and by other affiliates. This stock had been purchased from the Buckeye Union Casualty Company and the Buckeye Union Fire Insurance Company for an aggregate purchase price of $14,890,800, or nearly $70.00 per share. The principal stockholder in the Buckeye Union companies was Frederick E. Jones who was also Chairman of the Board and President of OSLICO.

5. At the time of the announcement of the 1965 exchange offer, OSLICO stock was trading at about $55.00 per share and Farmers stock was trading at $62.00 and above. OSLICO had twice as many assets as Farmers and its surplus was twice as large. Ohio State's per share equity was nearly three times that of Farmers and the earnings per share were nearly twice as large. Nevertheless, this voluntary exchange was consummated and, after Farmers Underwriters Association and the other affiliates tendered their shares, Farmers became the owner of 94.66 percent of Ohio State Life Insurance Company with 5.34 percent of the shares remaining in the hands of minority stockholders. The parties have agreed that the 1965 exchange ratio was not unfair to Farmers or to OSLICO, and there is no issue before the Court as to the fairness of the 1965 exchange.

6. The statement issued in connection with the exchange offer expressly stated that "[i]t is believed that the acquisition of shares of Ohio State Stock

in exchange for authorized but previously unissued [Farmers] stock may enable [Farmers] to accelerate substantially the rate of expansion of its life insurance business as a consequence of the resulting increase of its capitalization, though there is no assurance that these results would produce greater profits. It is not contemplated that, as a result of the Exchange, there will be any substantial change in the present organizational structure, personnel or methods of operation of Ohio State."

7. Since the 1965 exchange, Farmers and OSLICO have each split their stock two-for-one and Farmers has declared a 25 percent stock dividend, so that one 1965 OSLICO share is now two shares and one 1965 Farmers share is now 2.5 shares.

8. Between 1965 and 1972 Farmers did not buy or sell OSLICO stock so its holdings remained constant.

9. After the 1965 exchange, the Ohio State Life Insurance Company continued full operations as a separate entity. The Farmers New World Life Insurance Company also continued to issue its own policies. Thus, in a sense, Farmers continued to operate separately from OSLICO. However, Farmers now owned 94.66 percent of OSLICO and this percentage of the assets and liabilities of OSLICO was reflected on the balance sheet of Farmers. The result was that Farmers had expanded to include its old self plus most of the ownership of OSLICO. As a result of its ownership, Farmers closely supervised the management of OSLICO.

10. Farmers and OSLICO received a number of letters from OSLICO shareholders complaining of the fairness of the 1965 exchange. After the exchange only a relatively small number of OSLICO shares (5.34

percent) remained outstanding and there was no active market in the stock. Thus, the market price dropped significantly and was not a true reflection of the stock's value. After 1965 several OSLICO shareholders asked to be allowed to exchange their stock. They also requested that something be done to increase the marketability of their shares in OSLICO. The management of Farmers was concerned about this problem and was interested in finding a solution. A two-for-one stock split was declared in the hope that the increased number of minority shares would improve marketability, but this solution was ineffective. Farmers considered that it would be unfair to place bids in the market to buy the remaining shares since the price of the stock was artificially depressed.

11. In 1972 Farmers decided to acquire the remaining shares of OSLICO by effecting a merger. For tax purposes a reverse triangular merger was chosen and Farmers created FNW, a wholly owned subsidiary incorporated under the laws of the State of Ohio. The capital of FNW consisted of 53,398 shares of Farmers' stock. The Board of Directors and Shareholders of both OSLICO and F.N.W. approved the merger and the corporations were merged effective December 31, 1972 with OSLICO being the surviving corporation. In the merger Farmers' stock was distributed to OSLICO shareholders in substitution for their OSLICO stock. Through this transaction Farmers acquired 100 percent of the ownership of OSLICO shares.

12. The basis for the exchange in this 1972 merger was one share of Farmers for two shares of OSLICO.

13. During the third quarter of 1972 the high and low trading prices for OSLICO shares were 14-

10, and for Farmers shares 61-53¼. Based on 1971 earnings, and on September 1972 nine month earnings as estimated by defendants, the price/earnings ratios of the two stocks during the third quarter of 1972 were as follows:

	1971		*1972 (9 mos.)*	
	High	*Low*	*High*	*Low*
Farmers	34.0	28.0	53.5	46.7
OSLICO	9.5	7.9	9.2	6.6

14. In order for the merger to be completed, an affirmative vote of two-thirds of the OSLICO shares was required. Since Farmers already owned 94.66 percent of the shares and intended to vote them in favor of the merge, there was no question that the merger would take place. The OSLICO minority shareholders thus had the alternatives to either participate in the merger and exchange their shares or to exercise their rights as dissenters under Ohio Revised Code §1701.85, in effect selling their shares to Farmers for cash.

15. Certain of the minority shareholders declined to exchange their shares and exercised their dissenter's rights under Ohio law. Pursuant to statute an action was filed in the Court of Common Pleas of Franklin County, Ohio and three appraisers were appointed "to arrive at an appraisal of the fair cash value of the shares of Ohio State Life Insurance Company." Ohio Revised Code §1701.85(C) defines fair cash value as "the amount which a willing seller, under no compulsion to sell, would be willing to accept, and which a willing buyer, under no compulsion to purchase, would be willing to pay . . . . In computing such fair cash value, any appreciation or depreciation in

market value resulting from the proposal submitted to the directors or to the shareholders shall be excluded." The report of the appraisers concludes that the fair cash value of the OSLICO stock was $28.00 per share, and this report was adopted by the Court.

16. Although plaintiffs assert several claims, their basic complaint is that the exchange ratio of the 1972 merger was unfair. As indicated above, one share of Farmers was exchanged for two shares of OSLICO; expressed otherwise, the minority shareholder received one-half share of Farmers for each of his OSLICO shares. Plaintiffs contend that this ratio was grossly unfair and they pray to recover 2½ shares of Farmers for each share of OSLICO. The Court is thus faced with the central problem of evaluating the OSLICO stock. All parties acknowledge that the market price of OSLICO shares was not a true reflection of the value of the stock. With only 5.34 percent of the shares available, there was not an active market in the stock and its value was depressed.

17. Plaintiffs engaged Harold Deutscher, a professional actuary, as an expert witness on this subject. Mr. Deutscher undertook to calculate the "intrinsic value" of the stock. At the risk of oversimplification, we may characterize his approach as a calculation of the statutory book value plus an analysis of a block of business. Among other things he considered the equity of the business, the price/earnings ratio, the return on business in force and the expectations for future business. Using this method he assigned the OSLICO stock an intrinsic value of $30.27 per share. Through the same procedure a value of $20.67 a share was placed upon Farmers stock. Mr. Deutscher

gave no weight to the market prices of either company in arriving at his comparison. His reasoning was that in making a comparison he had to compare factors of the same type. Since there was no viable market for OSLICO stock, he had nothing to compare to the market price of Farmers stock. The purpose of his intrinsic value approach was to establish a basis for comparison of the two stocks. He hesitated to say, however, that $30.27 would be the proper cash price for the stock. He testified that if "I had to buy that stock and pay cash for it, I might want to review it and it might fall within a range of 28 to 32, or whatever, but the basic purpose of this evaluation was comparison with the other. There is perhaps a little difference between determining the price that I am going to pay cash for and one in which I am going to exchange paper for." (R. 98.) Deutscher's opinion was that the exchange was grossly unfair to the OSLICO minority shareholders. He felt that a fair exchange would have been 1½ shares of Farmer for each share of OSLICO. Under his analysis, the OSLICO shareholders received approximately one-third of what he felt they should have.

18. Mr. Robert Tookey, a consulting actuary, testified on behalf of defendants. He discussed the approach taken by Mr. Deutscher and expressed the opinion that Deutscher had failed to take into account the differences between the two companies. He felt that Deutscher had underestimated the value of Famers' agency force and the momentum and rate of growth of the company. He also felt that Deutscher should have considered the market value of the stock. Tookey also expressed the opinion that the exchange ratio suggested by Deutscher would have been unfair to

the stockholders of Farmers. According to Tookey, "Farmers management would have to pay the equivalent of $90.00 a share in Farmers stock, then selling for $60.00, for a stock that had sunk to a depth at one time I believe of $10.00, but the figures used in here I believe was $14.00, meaning that they would have had to justify somehow paying approximately 6½ times the market value of the Ohio shares in the hands of those minority shareholders." (R. 241.)

19. Defendants also called as an expert witness Philo Smith, an insurance stock analyst. Mr. Smith's opinion was that the 1972 exchange ratio was fair and reasonable. In arriving at this conclusion, he performed an analysis to determine "what would have been a fair market price for Ohio State Life at the time of the offer in October 1972." He in effect created a hypothetical market for OSLICO stock. This was done by looking at a group of companies which were comparable to OSLICO and which had active trading markets. Mr. Smith concluded that if OSLICO had had a reasonably good market it would have been selling at about $26.00 a share.

20. At one point Farmers worried that they were giving too much for the OSLICO stock. In order to facilitate what they considered to be a more equitable exchange, the management of Farmers considered declaring a twenty-five percent stock dividend prior to exchanging one share of their own stock for two shares of OSLICO. This idea was eventually rejected because they believed that the twenty-five percent stock dividend could be misunderstood by the OSLICO stockholders as an attempt to dilute the value of a share of Farmers and thus give them less than they were entitled to for their OSLICO stock.

21. A proxy statement was issued to the OSLICO shareholders in connection with the 1972 merger and a copy of this statement was introduced into the record as Joint Exhibit V(a). The plaintiffs contend that the proxy statement contained several material representations that were false or misleading. They particularly object to several instances where OSLICO is compared to Farmers considered as a separate company apart from its ownership in OSLICO. Page 13 of the proxy statement contains the following assertion:

> The difference in the rate of sales growth (volume of issues) of the separate companies is so pronounced that comparisons of earnings and equity values on a consolidated basis to those of Ohio State, separately, are meaningful only when the contributions of New World and Ohio State, each as separate companies, to the total combined growth in volume of business is taken into consideration.

This assertion is followed by a listing of the insurance issued and the insurance in force of Farmers and Ohio State as separate companies. Page 15 contains a comparison of first year's ordinary premiums and total ordinary premiums of the companies treated separately. Plaintiffs object that this is misleading because there was no such thing as a separate Farmers company. Farmers included 94.66 percent of OSLICO, and plaintiffs argue that the comparison should be between OSLICO and the "consolidated" company. It should be noted that the proxy statement contains several financial statements showing the condition of Farmers including 94.66 percent of OSLICO. It should also be noted that the presentations to which plaintiffs object also set forth the insurance issued, insurance in force,

first year's ordinary premiums and total ordinary premiums of the two companies 100 percent combined. In reality the OSLICO minority shareholder who exchanged his stock pursuant to this plan of merger would be getting in return shares in a company which consisted of Farmers plus 100 percent (not 94.66 percent) of OSLICO.

22. Plaintiffs also object that the figures referred to above were not given on a per share basis. At this time there were 2,000,000 shares of OSLICO and approximately 6½ million shares of Farmers issued and outstanding. Thus, a stockholder who owned one share in each company would have a different percentage of ownership in each company. However, none of the witnesses could recall having seen a statement showing such items on a per share basis. Defendants argue that the shareholder does not purchase an interest in first year ordinary premiums, for example, but in the total business. The shareholder has an interest in the equity of the company and in its earnings. On page 17 of the proxy statement the dividends paid, the adjusted stockholders' equity and the net gain from operations are given on a per share basis.

23. The plaintiffs make numerous other allegations concerning material omissions and misleading statements in the 1972 proxy statement. These allegations are set forth in the complaint and the final pretrial order, and the Court will not summarize them at this time. The primary objections are the failure to present certain figures on a consolidated basis and the failure to state certain items on a per share basis.

24. Plaintiffs also allege that defendants violated a fiduciary duty to the plaintiff class. This claim seems

to be made on two theories: (1) that the allegedly unfair 1972 exchange and the events surrounding that merger were a violation of fiduciary duty and (2) that the Farmers management had caused OSLICO to be operated in such a way that benefits accrued to Farmers instead of OSLICO, thus causing the value of OSLICO to decline.

25. In support of the first of these claims, plaintiffs assert that Farmers, as majority shareholder of OSLICO, had a fiduciary duty toward the minority shareholders. They also assert that OSLICO had such a duty toward its own stockholders. Plaintiffs contend that this duty was breached when defendants arranged and approved an exchange which was allegedly unfair to the minority stockholders. It is also alleged that the fiduciary duty was violated by defendants' failure to give the matter adequate and impartial consideration.

26. The fairness of this exchange will be considered at a later point in this opinion. The evidence showed that defendants were operating under time pressure in arranging this merger. They determined that if the merger were to take place in the near future it should be accomplished before the end of 1972 in order to avoid the burden of the additional reporting requirements of SEC Rule 145 which was to become effective January 1, 1973. The principal planning for the merger was done by Robert Early and Rocco DiFonso. Early was the President and Chief Executive Officer of Farmers Group and a director of Group, Farmers and OSLICO. DiFonso was Assistant Vice-President of Farmers and Vice-President Financial Development for Group. Early and DiFonso were thoroughly familiar with the financial reports of the two companies and worked with them on a daily basis. On or about October

10, 1972. Early decided what exchange ratio to recommend to the Boards of Directors of the two corporations. The exchange ratio was approved by the Boards of Directors of OSLICO and Farmers.

27. Plaintiffs also allege that Farmers used the capital and surplus of OSLICO to support its own issuance of insurance. The implication seems to be that this surplus was diverted from OSLICO's use to that of Farmers. It is true that Farmers' balance sheet reflected its interest in the assets and liabilities of OSLICO. Accordingly, 94.66 percent of the surplus of OSLICO appeared on Farmers' balance sheet. This surplus was then available to support new business of Farmers. Indeed, this had been one of the express purposes of the 1965 exchange. (See Finding of Fact Number 6, supra.) However, no capital or surplus was "contributed" by OSLICO. The assets of OSLICO remained in Columbus, Ohio. Mr. Tookey testified that this accounting treatment of the capital and surplus did not in any way detract from the availability of those assets to OSLICO and its stockholders. He also expressed the opinion that this capital and surplus was not actually necessary to enable Farmers to undertake the expansion which it had experienced since 1965. However, in 1971 R. C. von Rosenberg, President of Farmers, wrote a report to Mr. Early in which he stated that the "combining of [Farmers] and Ohio State Life assets has really turned us loose in writing enormous increases in life in Farmers New World." (Plaintiffs' Exhibit 1). The Court finds that the accounting treatment of these assets in no way deprived OSLICO of their use for the purpose of writing more business for itself.

28. The amount of Farmers' surplus was important because of accounting practices followed by the insurance industry. It is normal that the cost of issuing an insurance policy exceeds the first year premium. Under statutory accounting methods this entire cost must be charged against income in the year in which a policy is issued. Thus the operating statement normally shows the issuance of a policy as having produced a loss. Under generally accepted accounting principals [GAAP] the cost of acquiring a policy would be amortized over the life of the policy. Thus, the issuance of a certain policy would cause a "loss" under statutory accounting methods but would produce income under GAAP accounting. Prior to 1973 insurance companies were required to follow statutory accounting methods. Ironically, a company which was writing a lot of new insurance could easily put itself in a deficit position even though business was booming. This is true because the issuance of an increasing volume of new business would tend to affect adversely profits and surplus. Thus, as an *accounting* matter, the acquisition of 94.66 percent of OSLICO enabled Farmers to undertake the issuance of an increasing amount of insurance. However, the surplus of OSLICO was in no sense "used" or consumed, and it was still available to support the issuance of new business by OSLICO.

29. OSLICO and Farmers sold their policies through different types of agency forces. OSLICO had approximately 880 agents employed under a general agency system. Under this system, the OSLICO agent can represent many companies, but he can only represent those companies which will license him. The policies of OSLICO are sold only by general agents licensed with OSLICO and there are no Farmers agents

so licensed. The OSLICO agent typically does not sell casualty insurance and can be considered to be a professional life insurance agent. Because they concentrate on the sale of life insurance, the OSLICO agents have professional expertise which is generally superior to that of Farmers agents. This same consideration means, however, that the sole or principal source of income for this agent is commissions from the sale of life insurance.

Farmers and the principal members of Group (which does not include OSLICO) use a common agency force of approximately 6,950 direct writing agents. Farmers has an agency agreement with Group which provides that the Group agents will sell Farmers life insurance. In addition to selling life insurance, these direct writing agents sell other types of insurance products for the other companies affiliated with Group. Each agent is under exclusive contract with the insurer member of Group and each agent who is licensed to sell life insurance offers for sale only life policies written by Farmers. This limited representation is a requirement in coming with Farmers and the agents are told that only such restricted agents will represent Farmers. Under this direct writing system, an OSLICO agent would not be licensed to sell Farmers policies.

The Group agent's prospects for automotive, casualty and related types of insurance provide him with a broader base of customers and a natural market for life insurance. The wider selection of policies available under this multi-line agency approach also permits the maintenance of a larger sales force because the agents do not have to depend on making a living from the sale of one product.

The Group agent often will sell a life insurance policy as part of a package in connection with the sale of casualty insurance. OSLICO agents, on the other hand, must seek out persons who can be persuaded to buy life insurance alone. The OSLICO sales force typically sells to persons in higher income brackets than do the agents of Farmers and the average size of the life insurance policy is larger than that sold by Farmers agents. The type of agency force used by Farmers appears to have contributed to its marked growth.

30. Defendant Group owns 71.5 percent of Investors Guaranty Life Insurance Company [IGL], a life insurance company formed to provide a life insurance outlet for the exclusive use of mutual fund salesmen and broker-dealers. Effective in 1966 IGL entered into quota share (pro-rata) reinsurance agreements with Farmers and OSLICO, whereby each reinsurer assumed one-third of the business, paying certain expenses. (Although these are termed reinsurance treaties, they are in fact co-insurance treaties.) Plaintiffs charge that the co-insurance treaty enabled IGL to grow dramatically from 1966 to 1972 and that capital and surplus which belonged to one hundred percent of the shareholders of OSLICO was used to support the insurance writings of IGL.

In order to write new business IGL had to have available surplus. By co-insuring its business with Farmers and OSLICO, IGL kept more of its own surplus free to support new business. It was thus enabled to write more business than it could have without the co-insurance treaties. In this arrangement the OSLICO surplus was made available through the treaty between OSLICO and IGL. Because the OSLICO surplus was also reflected on the balance sheet of Farmers, it also figured in the treaty between IGL and Farmers. The surplus was not used or consumed, however, and OSLICO was not prevented from writing new business.

Under the statutory accounting principles discussed above, this reinsurance business resulted in accounting losses to OSLICO during the first few years. When restated in GAAP accounting principles, however, the coinsurance actually produced a profit. Mr. Tookey concluded that the co-insurance treaty was a fair deal for the reinsurers. The Court also finds that this co-insurance treaty did not represent a misuse of OSLICO assets by Farmers or IGL.

31. Plaintiffs also argue that Farmers and Group could have caused new business to be allocated to OSLICO instead of Farmers, thus causing OSLICO to experience the same marked growth that was experienced by Farmers. This contention seems to ignore state licensing requirements, the different types of agency forces, and the different types of insurance offered. The Court finds no evidence that business which could have been issued by OSLICO was diverted to Farmers.

Discussion

Although plaintiffs assert several theories of recovery, their claims center around three basic questions:

1. Was the 1972 exchange ratio unfair to the plaintiff class?
2. Was the proxy statement misleading?
3. Did defendants violate a fiduciary duty to the plaintiff class?

The answers to all of these questions seem to hinge on the fairness of the exchange. Because this is the

central issue in the case, the Court will proceed to discuss this question first.

Fairness of the Exchange

It is clear from the evidence that the market value of the OSLICO stock was not a true measure of its worth. Because of the relatively small number of shares available for trading, the price of the stock remained at the depressed level of $10.00 to $14.00 a share. It is therefore necessary to find some other measure of the stock's value. On this question the evidence is in fundamental agreement. Philo Smith calculated that a reasonable market price for the OSLICO stock would be $26.00 a share. The appraisers appointed by the Court of Common Pleas determined that $28.00 was the fair cash value of the stock. Plaintiffs' own expert found the "intrinsic value" of the stock to be about $30.00 a share. With this basic agreement concerning the value of the OSLICO stock, the problem becomes how to treat the Farmers stock in relationship thereto.

The Court believes that one has to look at the market value of the Farmers stock as an important factor in determining the fairness of this exchange. In our society the medium of exchange is money. According to the evidence, a cash price of $26.00 to $30.00 a share would have been a reasonable and fair offer for the OSLICO stock. Instead of purchasing the stock for cash, Farmers exchanged its own stock which was then trading at about $60.00 per share. At the exchange ratio of two shares of OSLICO stock for one share of Farmers, the minority shareholders received the equivalent of $30.00 a share for their stock. Had they been dissatisfied with the future pro-

spects of Farmers, the stock could easily have been sold for approximately $60.00 a share.

Mr. Deutscher calculated the intrinsic value of Farmers stock to be much lower than its trading price, and in his opinion the market had overvalued the stock. Deutscher particularly pointed out that the stock was selling at a high price/earnings ratio. The evidence indicates, however, that there was a solid and active market for Farmers stock. Some stocks sell at higher price/earnings multiples than others for a variety of reasons having mainly to do with growth and investor confidence. Farmers had experienced marked growth, and confidence in its prospects was high. An investor would probably want to consider the book value in assessing the stability of the market price and the long term prospects of this investment. If he were dissatisfied with the stock, however, he could have sold it for $60.00 a share, thus realizing $30.00 a share for his OSLICO stock.

Because there was no realistic market for OSLICO shares the intrinsic value approach is useful in arriving at a fair cash value for that stock. It is unrealistic, however, to then treat the "intrinsic value" of Farmers stock as the basis for the exchange. We know the *cash* value of Farmers stock. This is the basis for its trading on the securities market. It is nowhere quoted or bought and sold on the basis of its intrinsic value. The fair market value must be considered as a basis for the exchange of OSLICO shares.

It is true that the terms of the 1972 exchange were not as favorable to OSLICO shareholders as the terms of the 1965 exchange. In 1965 the parties ex-

changed share for share. (It should be noted that the "intrinsic value" of Farmers stock in 1965 was much less than that of OSLICO, but the voluntary exchange still took place.) Allowing for stock splits and stock dividends, the OSLICO shareholder who exchanged one share of stock in 1965 would have had 2.5 shares of Farmers stock in 1972. If the same shareholder had declined to exchange his stock, he would have had two shares of OSLICO in 1972. Thus, if the same exchange ratio had been used in 1972, the parties would have traded 2.5 shares of Farmers for two shares of OSLICO.

It appears to the Court that the plaintiffs want to be placed in a better position than they would have been in had they accepted the 1965 offer. As indicated, the OSLICO shareholder who exchanged one share of stock in 1965 would have had 2.5 shares of Farmers worth $150.00 in 1972. Had he kept the stock he would have two shares of OSLICO. Mr. Deutscher, whose proposed ratio was more modest than that stated in plaintiff's complaint, would exchange 1½ shares of Farmers for each share of OSLICO. Allowing for the split in OSLICO stock, this would mean that the shareholder would receive three shares of Farmers worth $180.00 for each share of OSLICO that he held in 1965. (This comparison is valid regardless of the market price since we are comparing Farmers stock to Farmers stock.)

The simple answer is that the OSLICO stock was worth less in relation to Farmers than it had been in 1965. Although OSLICO had shown slow and steady

growth, the growth of Farmers had been remarkable. Ohio State's net book value increased from $16,820,-176.00 on June 30, 1965 to $29,493,716.00 on Sepember 30, 1972. During the same period, Farmers' net book value increased from $8,374,988.00 to $27,918,-102.00 on its own and to a total of $55,836,913.00 when taking into account its 94.66 percent ownership of OSLICO. It would seem clear that the minority shareholders who declined to exchange their stock in 1965 made a poor economic decision.

Based upon all the evidence, the Court concludes that the exchange ratio in the 1972 merger was not unfair to the OSLICO minority shareholders.

Was the Proxy Statement Misleading?

It might be possible to stop the inquiry at this point. Since the exchange was fair, plaintiffs are unable to show any economic loss as a basis for their claims. In the interest of addressing all the issues, however, the Court will continue its analysis.

Plaintiffs allege that defendants violated a variety of state and federal securities laws. Their principal claim is made under Rule 10b-5 which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary

in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

An exchange of stock pursuant to a merger constitutes a "purchase or sale" of securities for purposes of §10(b) and Rule 10b-5. *S.E.C. v. National Securities, Inc.*, 393 U.S. 453 (1969); *Mader v. Armel,* 402 F.2d 158 (6th Cir. 1968), *cert. denied,* 394 U.S. 903 (1969). The parties have agreed that the mails were used in the solicitation of proxies of OSLICO minority shareholders.

In order to be actionable under Rule 10b-5, a misrepresentation or omission must be *material* to the decision to be made. The Supreme Court has stated that the facts withheld or misrepresented must be "material in the sense that a reasonable investor might have considered them important in the making of this decision." *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 153-154 (1972). In addressing questions of materiality, the Sixth Circuit has adhered to the test of "whether a reasonable man would have attached importance to the undisclosed facts in determining his choice of action in the particular transaction in question." *Arber v. Essex Wire Corporation,* 490 F.2d 414, 418 (6th Cir. 1974), *cert. denied,* 419 U.S. 830 (1974). Thus, the determination of whether or not there was a material misstatement or omission in the proxy statement must be made in the context

of the decision that the OSLICO shareholder was asked to make.

In this particular transaction the OSLICO shareholder was asked to vote for or against the proposed merger with FNW. Since Farmers already owned 94.66 percent of the shares and had announced its intention to vote those shares in favor of the merger, there was no question that the merger would take place. Thus, the real choice facing the OSLICO minority shareholder was whether to vote in favor of the merger and accept Farmers stock at the announced rate or to vote against the merger and exercise dissenter's rights under the Ohio Revised Code.

The fact that the votes of the minority shareholders were not necessary to permit the merger to take place does not mean that those votes were meaningless, however. All the shareholders of OSLICO, including the minority, had the right to express their opinion of the merger by voting for or against the proposed action. In order for such a vote to be meaningful, it was necessary for each shareholder to have sufficient information to make an informed decision. The votes of the minority shareholders had value whether or not their approval was essential to authorize the merger. *See Schlick v. Penn-Dixie Cement Corporation,* 507 F.2d 372 (2d Cir. 1974), *cert. denied,* 421 U.S. 976 (1975). Thus, the minority shareholder of OSLICO had two decisions to make. The ostensible purpose of the proxy statement was to solicit his vote on the question of the proposed merger. In light of the control exercised by Farmers, however, the real choice facing the minority shareholder was whether to exchange his stock in the merger or to exercise his dissenter's rights under Ohio law. The Court will thus

address the question of materiality in the context of these decisions.

The plaintiffs have made numerous allegations concerning material omissions and misleading statements in the 1972 proxy statement. As the Court has indicated in the findings of fact, the primary objections are the failure to present certain figures on a consolidated basis and the failure to state certain items on a per share basis. It is the opinion of the Court that none of these alleged omissions or misleading statements was material to the decisions to be made or represents violations of the applicable securities laws.

Plaintiffs particularly object to several instances where OSLICO is compared to Farmers considered as a separate company apart from its ownership in OSLICO. (See Finding of Fact 21). The Court recognizes that the relationship of Farmers and OSLICO in 1972 presented a difficult conceptual problem. In terms of operations there were two companies with separate agency forces issuing separate insurance policies. In terms of financial statements, however, Farmers did not exist separately but included 94.66 percent of OSLICO. In this context the Court does not believe that the proxy statement was false or misleading. In determining his course of action, the shareholder might well want to consider that the volume of sales of Farmers policies was growing at a much higher rate than that of OSLICO policies. In this respect the statements in question amount to fuller disclosure rather than a failure of disclosure. The proxy statement as a whole contains several financial statements showing the condition of Farmers including 94.66 percent of OSLICO. The statement also contains figures showing the effect of the one hundred percent combination

of the two companies which would result from the merger. The Court therefore concludes that this comparison of Farmers and OSLICO as separate companies was not materially misleading.

Neither was the failure to state certain items on a per share basis a material omission. None of the witnesses could recall having seen a statement showing such items on a per share basis. The proxy statement does give the per share figures for dividends paid, adjusted stockholders' equity and net gain from operations—figures which are customarily given on a per share basis. Had a particular stockholder been interested in learning the per share level of ordinary premiums, for example, the proxy statement contains ample information from which to make this calculation.

It is also argued that the proxy statement was misleading because it misrepresented the amount and thoroughness of the consideration given to determining the 1972 exchange ratio. Presumably, if a stockholder thought that the officers and directors of OSLICO had given inadequate consideration to the matter, he would be more likely to critically examine the plan of merger. The evidence indicates that the officers and directors considered many factors, including the impaired marketability of OSLICO stock and the benefits to the minority shareholders from such an exchange. All these persons were familiar with the financial status of the company. The evidence indicates that the merger was given due consideration and the proxy statement was not materially misleading.

Plaintiffs make numerous other allegations of misleading statements and material omissions. These include failure to state the 1965 exchange ratio, failure

to cite the lack of outside consultation in determining the exchange ratio, failure to include an analysis of the price earnings ratios of the two stocks, stating that each member of the Board of Directors intended to vote in favor of the transactions, and numerous other allegations. In the years since the 1965 exchange there had been significant changes in both companies and the two situations were not comparable. There was no duty to engage outside consultants and nothing was said which might have led the stockholder to believe that such consultation had taken place. It would be a simple calculation to determine the price earnings ratio from the information contained in the proxy statement. However, such a comparison might have been misleading since the parties agree that the price of OSLICO stock was artificially low. The statement that each member of the Board of Directors intended to vote in favor of the transaction was true. It is also true that the directors collectively had only a nominal amount of stock and that their votes would have little economic significance. The statement was made, however, as a reflection of the opinions of the directors and not to indicate the economic significance of their votes.

The Court sees no point in reproducing all of these allegations, many of which are frivolous, in what is already a lengthy opinion. The Court has considered each allegation in light of the appropriate legal standards and the evidence offered and finds that the alleged omissions were not material and that the challenged statements were not materially misleading. In sum, the Court concludes that the 1972 proxy statement did not violate Rule 10b-5.

Plaintiffs have also alleged that defendants violated §14 of the Securities Exchange Act, 15 U.S.C. §78n(a), and the rules and regulations promulgated thereunder. However, §14 by its terms applies only to the solicitation of proxies "in respect of any security . . . registered pursuant to section 12 of this title." Thus, in order for plaintiffs to invoke §14, they must show that OSLICO was subject to the registration provisions of §12. Plaintiffs concede in their brief, however, that OSLICO and Farmers are both exempt from Section 12 registration. Only defendant Group is registered under Section 12. The Court therefore finds that Section 14 of the Securities Exchange Act is inapplicable to this case.

The Court further finds that there was no violation of Ohio Revised Code §3901.31(D) or Rule IN-1-02 promulgated thereunder. The evidence indicated that defendants complied fully with the procedural requirements of Ohio law and obtained the approval of the Merger Commission. Plaintiffs have in effect conceded that the proxy statement complied with the formal requirements of the Ohio law. They seem to argue, however, that more than the minimum was required in order to make this proxy statement not false or misleading. The Court has fully discussed plaintiffs' allegations in connection with its finding that there was no violation of Rule 10b-5. The same conclusion must be reached here. The plaintiffs have failed to convince the Court that there are any more stringent requirements of Ohio law which have been violated here.

Thus, having addressed the question in light of the evidence and the various theories of liability asserted

by plaintiffs, the Court concludes that the 1972 proxy statement was not misleading.

Fiduciary Duty

Plaintiffs have also alleged that defendants, as majority shareholders, violated their fiduciary duty toward the minority by forcing this merger on unfair terms. Of course claims for breach of fiduciary duty are normally heard under state law. In light of developing federal case law, however, these allegations must also be considered as purporting to state a claim under Rule 10b-5.

In addition to prohibiting misrepresentations and failures to disclose material information, the text of Rule 10b-5 also forbids the employment of "any device, scheme, or artifice to defraud" and engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." In their brief and at trial defendants cited several cases which stand for the proposition that Rule 10b-5 does not apply to the issue of fairness. Typical of these cases is *Dreier v. The Music Makers Group, Inc.*, CCH Fed. Sec. L. Rep. ¶94,406 (S.D. N.Y. Feb. 20, 1974), which states that: "the treatment of the minority shareholders may well have been grossly unfair but it was completely open. Under these circumstances plaintiff's remedy is a state court action for appraisal. . . ." It was the position of these cases that nondisclosure was an essential element in any Rule 10b-5 action. Very recently, however, the Second Circuit has decided two cases which appear to substantially broaden the scope of actions under Rule 10b-5. *Marshel v. AFW Fabric Corp.*, CCH Fed. Sec. L. Rep. ¶95,448 (2d Cir., Feb. 13, 1976); *Green v. Santa Fe Industries,*

Inc., CCH Fed. Sec. L. Rep. ¶95,447 (2d Cir., Feb. 18, 1976). The issuance of this opinion has been delayed so that the Court could obtain and consider copies of these decisions.

Marshel v. AFW Fabric Corp., supra, presented an attempt by majority shareholders to have a corporation "go private" by means of a merger. Prior to July, 1968, Concord Fabrics, Inc. was a private corporation owned entirely by the Weinstein family. As a result of public offerings the Weinsteins came to own approximately 68 percent of Concord's stock while the remaining 32 percent was publicly held. The price of the stock in the public offerings had been $15.00 and $20.00 per share. After it became a public corporation, Concord's earnings fluctuated considerably and its stock sold as low as $1.00 per share in late 1974.

In January, 1975 the Weinsteins initiated a plan to eliminate the public stockholders of Concord and return the company to the private ownership of the Weinstein family. They formed AFW and transferred to it shares representing their 68 percent ownership of Concord. In return the Weinsteins received 100 percent of AFW's stock. AFW's only function was to serve as a vehicle for the proposed merger. AFW then made a tender offer for all the publicly held Concord shares at a price of $3.00 per share. This purchase was to be financed through bank loans to AFW which would ultimately become the obligations of Concord. At that time AFW made known its intention to cause a merger between itself and Concord regardless of whether any shares were tendered. Because of the percentage of Concord stock owned by AFW the minority stockholders would be unable to prevent the merger by voting against it at the shareholder's

meeting. Under the state merger statute, appraisal rights were the exclusive remedy provided for dissenting shareholders.

The AFW tender offer was subsequently withdrawn, but the plan of merger was initiated. Under the terms of the merger the Weinsteins, as sole stockholders of AFW, would receive all the stock of the surviving corporation while the public shares in Concord would be cancelled for $3.00 per share. The proxy statement clearly disclosed that the purpose of the merger was to return the company to the status of a privately owned corporation controlled entirely by the Weinstein family. The proxy statement also revealed that the effect of the merger would be that without any additional investment on the part of the Weinstein family their interest in the equity and earnings of the corporation would be increased from 68 percent to 100 percent.

Plaintiffs, public stockholders of Concord, filed suit alleging violations of Section 10 and Rule 10b-5 and seeking a preliminary injunction against the proposed merger. They argued that the merger served no legitimate corporate purpose but was designed to eliminate public shareholders by giving them inadequate compensation for their shares. Thus the merger was, they alleged, a device, scheme and artifice to defraud, in violation of Rule 10b-5. Although plaintiffs also alleged a variety of misrepresentations and nondisclosures in the proxy statement, the district court found these allegations to be without merit. The Court further found that "[p]laintiffs' claims that there has been a Rule 10b-5 violation because of the unfair and inadequate price to be paid for the Concord shares and the absence of a bona fide corporate purpose for the merger are patently without merit. Rule 10b-5 simply

does not encompass these alleged wrongs." *Marshel v. AFW Fabric Corp.*, 398 F.Supp. 734, 738 (S.D. N.Y. 1975). Accordingly, a preliminary injunction was denied.

The Court of Appeals disagreed and reversed the decision of the district court, holding that the "challenged conduct constitutes a violation of Section 10(b) and Rule 10b-5. . . ." In reaching its decision the Court of Appeals emphasized a number of factors including the lack of a legitimate corporate purpose in carrying out the merger, the breach of fiduciary duty, and the fact that the Weinsteins would obtain the entire stock ownership of Concord "at a price determined by them and paid out of the corporate treasury at a cost of over $1,600,000.00." This amounted to "an attempt by the majority stockholders to utilize corporate funds for strictly personal benefit." The Court held that "when controlling stockholders and directors of a publicly held corporation cause it to expend corporate funds to force elimination of minority stockholders' equity participation for reasons not benefiting the corporation but rather serving only the interests of the controlling stockholders such conduct will be enjoined pursuant to Section 10(b) and Rule 10b-5 which prohibits 'any act, practice, or course of business which operates or would operate as a fraud . . . in connection with the purchase or sale of any security.' "

In the course of its opinion the Court sought to distinguish its decision in *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972) which had been understood by the district court to require nondisclosure as an essential element of a Rule 10b-5 claim. The Court of Appeals thought that "it would surely be anomalous to hold

that a cause of action is stated under §10(b) and Rule 10-5 when the fraudulent conduct in connection with a purchase or sale of securities includes deception but that similarly fraudulent practices carried out with prior disclosure to the helpless victim did not give rise to a Rule 10b-5 claim."

In *Green v. Santa Fe Industries, Inc., supra,* former minority shareholders of the Kirby Lumber Corporation brought suit alleging Rule 10b-5 violations and pendent claims. Before the challenged merger had taken place, approximately 95 percent of the stock of Kirby Lumber Corporation had been owned by Santa Fe Natural Resources, Inc. [Resources]. Resources in turn was a wholly owned subsidiary of Santa Fe Industries, Inc. [Santa Fe]. Resources decided to obtain the remaining shares of Kirby stock by effecting a short form merger under Delaware law. To facilitate this merger Forest Products, Inc. [FPI] was organized as a Delaware corporation. FPI then issued all of its stock to Resources in return for the approximately 95 percent of the Kirby shares owned by Resources, some cash, and the assumption of certain liabilities. The board of FPI then adopted a resolution providing that FPI would be merged into Kirby with Kirby to be the surviving corporation. The minority shareholders would receive $150.00 per share in cash or could exercise their appraisal rights under the Delaware statute.

Under the Delaware short form merger procedure, the merger became effective without notice to the minority shareholders. The next day they were mailed a notice of the merger and an information statement explaining the terms of the merger and setting forth various financial data. Also contained in this information was a statement by an accounting firm placing the value of the minority shareholders' stock at $125.00 per share. Instead of tendering their stock, plaintiffs made a demand for appraisal. They later purported to withdraw that demand and filed suit in federal court.

Plaintiffs contended that their stock was worth at least $772.00 per share and alleged that the short form merger allowed the minority shares to be acquired at a "grossly undervalued price." This forced sale at a gross undervaluation was asserted to be a "device, scheme, or artifice to defraud" actionable under Rule 10b-5. It was also alleged "that without any misrepresentation or failure to disclose relevant facts, the merger itself constitutes a violation of Rule 10b-5 because the mulcting of the minority shareholders is accomplished by a breach by the majority of its fiduciary duty to deal fairly with the minority who in effect are the *cestuis* of the majority. This breach of fiduciary duty is the forcing of the minority to sell their stock at far less than it is worth against their will, and even without any opportunity to seek premerger relief from the courts, all for the enrichment of the majority who continue to hold their stock. All this is alleged to be done at the expense of the corporation without any corporate purpose justifying the expenditure."

The district court dismissed the complaint for failure to state a claim, holding that "[a]t least, if full and fair disclosure is made, transactions eliminating minority interests are beyond the purview of Rule 10b-5." 391 F.Supp. at 854. The Court of Appeals reversed, holding that "misrepresentation or lack of disclosure are not essential ingredients of the claim for relief by the minority."

In distinguishing the *Popkin* case, the Court noted that the procedure in that case provided for prior shareholder approval and a corporate business purpose was being served. By contrast, in the *Green* case there was no advance notice and the minority thus had no opportunity to seek injunctive relief from the courts. The Court of Appeals held "that a complaint alleges a claim under Rule 10b-5 when it charges, in connection with a Delaware short form merger, that the majority has committed a breach of its fiduciary duty to deal fairly with minority shareholders by effecting the merger without any justifiable business purpose. The minority shareholders are given no prior notice of the merger, thus having no opportunity to apply for injunctive relief, and the proposed price to be paid is substantially lower than the appraisal value reflected in the Information Statement. We do not hold that the charge of excessively low valuation by itself satisfies the requirements of Rule 10b-5 because that is not the case before us." This decision was reached over vigorous dissent. Judge Moore insisted that "the majority has found a fraudulent scheme and hence a violation of Rule 10b-5 where none exists."

Although the form of merger at issue here is similar to that employed in *Marshel* and *Green*, there are several factors distinguishing the cases. First, it is important to note that neither case held that a forced merger which eliminates minority shareholders is a *per se* violation of Rule 10b-5. The circumstances of each challenged merger must be examined to determine whether the transaction would operate as a fraud. Central to such a determination, of course, is a finding that the consideration offered in return for the minority shares is inadequate. Mere inadequacy of consideration

may not be sufficient to prove a claim, however, since the Court is *Green* specifically stated that it was not holding that the "charge of excessively low valuation by itself satisfies the requirements of Rule 10b-5 . . . ." The Court has already addressed this issue and has found that the 1972 exchange ratio was not unfair to plaintiffs.

The two cited cases also emphasize the lack of any corporate purpose in carrying out the transaction. In both cases it was charged that the majority was forcing out the minority solely for the purpose of enriching itself. The avowed purpose of the merger currently before the Court was of course to give Farmers complete ownership of the OSLICO shares. Farmers felt that it was in its interest to own one hundred percent of the OSLICO stock and decided to accomplish this before more burdensome government regulations went into effect. This merger was also a method of solving the problem of the impaired marketability of the OSLICO shares held by the minority. The Court has indicated that a previous stock split had failed to improve the marketability of the stock. Through this merger Farmers and the OSLICO management presented the OSLICO minority shareholders with an opportunity to exchange their stock at twice its market price. The Court does not mean to say that the motives for the merger were wholly altruistic but only to point out that the merger was not designed solely to serve the interests of the majority shareholders. At the shareholders meeting 77 percent of the minority shareholders voted in favor of the merger.

The *Marshel* case also presents an instance of egregious self-dealing. Having previously sold stock to the public at $15.00 and $20.00 a share, the Weinsteins

were attempting to take advantage of the market conditions to, in effect, forcibly repurchase the stock at $3.00 a share. Moreover, the family was making no further investment but was causing Concord to finance the liquidation of the minority interest. In the present case Farmers was not in the position of repurchasing stock at bargain prices. In fact, Farmers had offered to purchase this stock in 1965. The fact that the value of OSLICO stock had dropped since that time does not make this transaction improper. Moreover, Farmers was making a further investment, having contributed more than 50,000 shares of its own stock to FNW for the purpose of effectuating the exchange. Although there was some expenditure of corporate funds in connection with the merger, it cannot be said that these funds were expended for reasons serving only the interests of the controlling stockholders.

In contrast to the minority in *Green,* the OSLICO minority had advance notice of the proposed merger and an opportunity to seek injunctive relief. All the shareholders of OSLICO were asked to approve or disapprove the merger. Most importantly, there was no undervaluation of the minority shares which would operate as a fraud upon the plaintiffs. Although recent decisions extend the scope of Rule 10b-5 to include allegations of breach of fiduciary duty, no such breach occurred here. Even allocating the burdens of proof according to the teachings of *Pepper v. Litton,* 308 U.S. 295, 306 (1939), the evidence does not support a finding that the defendants in this action breached their fiduciary duty toward the minority shareholders of OSLICO.

The surface similarities between the present case and the situations presented in *Green* and *Marshel*

should not be permitted to obscure the fundamental differences which exist. In planning and carrying out the 1972 merger, the management of Farmers had to fulfill fiduciary duties to its own shareholders as well as to the minority shareholders of OSLICO. The OSLICO management recognized that its minority shareholders were being offered an opportunity to exchange a relatively unmarketable stock for an actively traded stock. Although the *Marshel* and *Green* decisions seem to require the Court to closely scrutinize this transaction, it is not required to substitute its own business judgment for that of the persons here involved. Considering all of the evidence, the Court cannot say that the defendants were taking advantage of the minority or were profiting unfairly from this transaction. The 1972 plan of merger was not a "device, scheme, or artifice to defraud" nor did it constitute an "act, practice, or course of business which operates or would operate as a fraud . . ."

Plaintiffs' allegations of a breach of fiduciary duty go far beyond the terms of the 1972 merger. They contend that the whole course of dealings between 1965 and 1972 shows that Farmers managed OSLICO for the benefit of Farmers and to the detriment of OSLICO and its minority shareholders. The allegations concerning the accounting use of OSLICO's surplus, the reinsurance treaties, the use of the sales forces and the allocation of business are all intended to support this charge. Even if plaintiffs were to accept the proposition that OSLICO stock was comparatively less valuable in 1972 than it was in 1965, they would contend that this relative decline in value was due to Farmers' breach of fiduciary duty in managing OSLICO.

The evidence is to the contrary. Numerous exhibits show that Farmers was concerned about the rather conservative performance of OSLICO and hoped to change this through encouraging new and more aggressive policies. It must be remembered that OSLICO had historically been a solid but conservative company whereas Farmers had been experiencing impressive growth. The different agency systems employed by the two companies helped to account for the differences in performance.

As principal owner, Farmers had a substantial and vested interest in the growth and prosperity of OSLICO. In fact, the performance of OSLICO was directly reflected on the balance sheet of Farmers. Although the accounting treatment of OSLICO's surplus benefitted Farmers, this in no way deprived OSLICO of the use of its surplus for supporting the issuance of new business. Far from reflecting deliberate mismanagement, a comparison of financial statements shows that the net book value of OSLICO nearly doubled from 1965 to 1972. Whether the plaintiffs' claims are considered under federal securities law or under state law, the Court finds that their charges of violation of fiduciary duty are without merit.

Conclusions Of Law

1. This Court has jurisdiction of the subject matter under the provisions of federal securities law and the doctrine of pendent jurisdiction.

2. This Court has personal jurisdiction over the parties herein.

3. The exchange ratio in the 1972 merger was not unfair to the OSLICO minority shareholders.

4. The 1972 proxy statement was not misleading.

5. There was no breach of fiduciary duty by the defendants.

6. The 1972 merger and the events leading thereto did not operate as a fraud or deceit.

7. Plaintiffs are not entitled to relief.

WHEREUPON, IT IS ORDERED THAT the Clerk of this Court shall enter judgment for the defendants.

/s/ Joseph P. Kraneary
United States District Judge

Service of the within and receipt of a copy thereof is hereby admitted this ..... day of May, A.D. 1978.

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